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SUBJECT: TURKEY/IMF: PROGRESS ON BUDGET, OTHER ISSUES REMAIN

REF: ANKARA 5637

11. (Sbu) Summary: In an important sign of progress in discussions of a new Standby program, the GOT has publicly agreed to a 6.5% primary surplus target for 2005. Local IMF staff privately confirm that the GOT's primary surplus target accords with the IMF definition and that the GOT can now move forward with a budget the broad outlines of which meet IMF approval. While the highest profile issue seems to have been satisfactorily addressed, myriad other issues remain to be worked out before agreement is reached on a letter of intent for a new Standby, including 2006-7 fiscal targets, progress on the banking law, and specific tax measures. End Summary.

Surprise Concession on the 2005 Primary Surplus:

12. (Sbu) In a surprise to markets and the IMF staff, the GOT agreed to accept a 6.5% primary surplus target for 2005. Whereas GOT officials had been pressing the IMF mission (reftel) to accept a primary surplus of only 5 or 5.5%, the GOT announced late Tuesday that the 2005 target would be 6.5%. The announcement was made October 13 by Deputy Prime Minister Sener, following a meeting of the High Planning Council and confirmed by Economy Minister Ali Babacan. At the same time, Sener announced the broad outlines of the budget including other, less controversial targets: 5% for GDP growth, 8% for inflation, and TL 156 Quadrillion (\$104 billion) for total expenditure.

13. (Sbu) According to the IMF Deputy Resrep, the announcement represented GOT acceptance of the IMF staff's push for a primary surplus of at least 6.5%. Whereas Fund staff had been concerned the GOT might try to fudge the numerical target by altering the definition, he confirmed that the 6.5% number announced Tuesday followed the standard IMF definition. He also confirmed that the 2005 draft budget -- or at least its principal targets and broad outlines -- was the result of consultation with the Fund team currently in Ankara. Having reached general agreement on next year's budget, the GOT can move ahead to submit the budget to the Parliament on October 17.

14. (Sbu) The GOT reversal left observers scratching their heads about the internal dynamics of GOT decision-making. The Deputy Resrep was mystified about what had caused the turnaround, since the GOT had been pushing hard on the need for a lower target. A well-informed private sector observer commented that this was another demonstration of the weight Babacan's and Sener's views carry in AK Party decision-making circles.

Myriad Issues Remain:

15. (Sbu) The IMF staffer cautioned that many issues remain to be resolved before a letter of intent could be signed. Even the 2005 budget, for example, needs to be fleshed out with details of how the primary surplus target will be achieved. He pointed out that the agreed budget outlines mostly concern the central government, whereas the 6.5% target is for the entire public sector, leaving many of the detailed policies relating to the rest of the public sector to be worked out. Nor have fiscal targets been agreed for 2006 or 2007.

16. (Sbu) Specific tax measures -- another contentious issue with the IMF -- also remain on the table. The Deputy Resrep said that GOT technocrats' earlier ideas about cutting Value-added Taxes and compensating with increases in the Special Consumption Tax on certain products, did not meet the approval of Prime Minister, who reportedly was less than enthused at the prospect of compensating a VAT cut with other taxes. The Deputy Resrep admitted the Fund might be able to accept a very slight reduction in VAT taxes but that the devil will be in the details. Moreover, he did not rule out that VAT cuts could reemerge as a GOT proposal after the budget process is completed.

17. (Sbu) On the banking law, he said much work remained to be done, though the GOT had agreed on a process that Fund Staff

felt was encouraging. After the BRSA finishes its re-write, the draft law will go to the government. Since the BRSA, most of whose leaders are "sworn auditors," is unlikely to make the necessary compromises relating to the privileged power these auditors, the GOT has agreed to establish an interagency drafting committee. The committee would be dominated by GOT officials, though the BRSA would be represented. The Deputy Resrep said the key is GOT political will to change the draft, the technical work itself should not be that time-consuming.

Tricky Timing for a Board Vote:

18. (Sbu) Now that the pressure of the budget deadline is off, the Deputy Resrep said the Fund staff was in no rush to reach agreement on the many outstanding issues. Given that the negotiations are over a three-year program, rather than a review, and there is no immediate financing need, Fund staff are inclined to take their time and make sure the issues are carefully worked out. While he thought the current mission might have to stay longer than their planned departure date of October 26, he was hopeful they could wrap things up without an additional mission.

19. (Sbu) Once all the issues are worked out, the Deputy Resrep said the timing of a board vote could be tricky. On the one hand, the Fund staff may want to be sure the parliament passes the budget before going to the board. On the other hand, the Fund might be reluctant to let the board vote get too close to the EU's December 17 decision on Turkish Accession, or to be perceived as overly skeptical of GOT commitments to pass its budget.

EDELMAN